No. 77-648

IN THE
Supreme Court of the United States
OCTOBER TERM, 1977

FEDERAL ENERGY REGULATORY COMMISSION,
Petitioner
v.
PENNZOIL PRODUCING COMPANY, *ET AL.*,
Respondents.

On Petition For A Writ of Certiorari To the United States Court of Appeals For The Fifth Circuit

BRIEF OF RESPONDENT UNITED GAS PIPE LINE COMPANY IN OPPOSITION

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BRIEF OF RESPONDENT UNITED GAS PIPE LINE COMPANY IN OPPOSITION

Respondent United Gas Pipe Line Company (United) submits the following brief in opposition to the petition for a writ of certiorari which has been filed by the Federal Energy Regulatory Commission (Commission).[1]

1. On September 30, 1977, the Federal Power Commission ceased to exist and its functions were transferred to the Secretary of Energy and the Federal Energy Regulatory Commission, which was activated on October 1, 1977. References to the Commission are to the Federal Power Commission prior to October 1, 1977, and to the Federal Energy Regulatory Commission on and after October 1, 1977.

STATEMENT OF THE CASE

Pennzoil Producing Company (Pennzoil) and Shell Oil Company (Shell) sell natural gas produced from the Gibson Field, Terrebonne Parish, Louisiana, to United. A portion of the gas sold to United is produced from acreage covered by leases from Williams, Inc., *et al.* (Williams). The prices Pennzoil and Shell are permitted to collect from United for the sale of the gas are subject to Commission jurisdiction under the Natural Gas Act, 15 U.S.C. § 717 *et seq.*, and to the applicable just and reasonable rates established by the Commission. Williams, however, has claimed that under its leases it is entitled to the payment of royalties on the basis of the market value of the gas rather than on the basis of the regulated price.[2] As a result of this claim, Pennzoil and Shell asked a Louisiana state court to declare that Pennzoil and Shell were paying correct royalties.[3] By reconventional demand Williams asked the state court to declare the leases terminated, to assess damages for the alleged underpayment of royalties, and, in the event the leases were not terminated, to declare that future royalties must be based on prices alleged by Williams to be the market value. Subsequently, Pennzoil, Shell and Williams entered into a settlement agreement. Pursuant to its terms, Pennzoil and Shell sought Commission authorization to collect increased rates from United which would reflect the increase in royalty costs as provided for in the settlement agreement, or, alternatively, in the event the Commission denied the requested increases,

2. *Texas Oil and Gas Corp. v. Vela*, 429 S.W.2d 866 (Tex. 1968); *Lightcap v. Mobil Oil Corp.*, 562 P.2d 1, *cert. denied*, October 3, 1977, No. 76-1694.

3. *Shell Oil Co. and Pennzoil Producing Co. v. Williams, Inc., et al.*, Civil District Court for Orleans Parish, Louisiana, Docket No. 573-591 (filed May 24, 1974);

Pennzoil and Shell sought Commission authorization to abandon the sale of the royalty portion of the gas to United.

United intervened in the Commission proceedings on the basis of letter agreements it had executed with Pennzoil and Shell in which United agreed, subject to Commission approval, to pay the increased rates, or, alternatively, to release the royalty portion of the gas from its gas purchase contracts. United executed these agreements after being advised of the pending market value royalty litigation, its possible adverse results, and that in an effort to settle the litigation, Pennzoil and Shell had entered into the settlement agreement with Williams. United took the position that it preferred Commission approval of the increased rate alternative, it being understood that the increases would be reflected in United's jurisdictional rates. Commission approval of this alternative would ensure that all of the gas attributable to the Williams' acreage would remain available to United and its customers. However, if the rate alternative were denied, United then supported Commission approval of the abandonment alternative. Commission approval of the abandonment of the royalty portion of the gas was preferable to the risk of lease cancellation and possible loss of all the gas to the interstate market and would at least keep the working interest portion available to United.

The Commission denied Pennzoil's and Shell's requests for increased rates by holding that it did not have the authority to allow producers increased rates based upon increased royalty costs calculated on a rate in excess of the Commission's just and reasonable rates. In denying the requests for abandonment authorization, the Commission held that neither of the two conditions for

abandonment under Section 7(b) of the Natural Gas Act, 15 U.S.C. § 717f(b), had been met. The Commission found first, that the supply of gas had not been depleted and second, that the present or future public convenience or necessity did not require that abandonment be authorized. The Commission relied upon its Opinion No. 737,[4] for its determination that even if the litigation with Williams were lost and Pennzoil's and Shell's leases were terminated, the gas would remain committed to the interstate market.

On appeal, the United States Court of Appeals for the Fifth Circuit reversed the Commission. The Fifth Circuit held that the Commission erred in failing to realize it had the authority to permit rate relief, as this Court previously had held in *Mobil Oil Corp. v. Federal Power Commission*, 417 U.S. 283 (1974), and remanded the rate relief issue for a determination as to whether the relief requested should be granted. Further, the Fifth Circuit reversed and remanded for further consideration the Commission's rejection of the abandonment alternative. Relying on its decision in *Southland Royalty Co. v. Federal Power Commission*, 543 F.2d 1134 (5th Cir. 1976), *cert. granted*, June 27, 1977, *Federal Power Commission v. Southland Royalty Co.*, No. 76-1587, which reversed Opinion No. 737, the Fifth Circuit held that in denying the abandonment requests, the Commission had acted under the wrong legal premise in assuming that the gas would remain committed to the interstate market if the leases were cancelled as a result of the state court litigation.

4. *El Paso Natural Gas Co.*, Opinion No. 737, Docket No. CP75-209 (July 11, 1975), *reh'g denied*, Opinion No. 737-A (September 3, 1975).

REASONS FOR DENYING THE WRIT

I.

THE COMMISSION HAS AUTHORITY TO GRANT INDIVIDUALIZED RELIEF TO NATURAL GAS PRODUCERS FOR ROYALTIES ACTUALLY INCURRED.

1. This Court's opinion in *Mobil Oil Corporation v. Federal Power Commission* expressly authorized the granting of relief from royalty obligations based upon a price higher than the regulated rate.

In its Petition, the Commission has posed the question whether the Commission has authority to grant to natural gas producers individualized rate relief for royalty costs actually incurred when those costs are based on the unregulated market price of natural gas. This question has been answered in the affirmative by the Court of Appeals for the Fifth Circuit in *Placid Oil Co. v. Federal Power Commission*, 483 F.2d 880 (5th Cir. 1973), and by this Court in *Mobil Oil Corp. v. Federal Power Commission*, *supra*, affirming *Placid*.

In *Placid*, the Fifth Circuit reviewed and upheld the Commission's Opinion No. 598 which established area rates for Southern Louisiana, and, in response to Mobil Oil Corporation's complaint that the Commission failed to provide for an adjustment in area rates to compensate for anticipated higher market value royalty costs, the Fifth Circuit stated:

> "If as subsequent events develop, the producers are put in a bind by their royalty obligations, they may

certainly petition the FPC for individualized relief. *Permian* contemplated it." 483 F.2d at 911.

Placid was affirmed by this Court *sub nom. Mobil Oil Corp. v. Federal Power Commission, supra,* in which this Court expressed complete agreement with the Fifth Circuit:

> "Mobil argues that . . . the 1971 rate schedules must take into account the possibility of higher royalty obligations. We agree with the Court of Appeals that Mobil's argument is hypothetical at this stage and that in any event an affected producer is entitled to seek individualized relief." 417 U.S. at 328.

The claim for higher royalties and the state court litigation have put Pennzoil and Shell in the bind mentioned in *Placid.*[5] As the Fifth Circuit noted in its opinion below:

> "Pennzoil and Shell have been put in such a bind. If they lose the state court litigation, they are faced either with termination of their leases, which could divert the entire amount of gas from interstate commerce, or with increased royalty payments, which would absorb funds otherwise available for exploration and development." 553 F.2d at 488.

5. Assuming that it does not have the authority to grant relief to a producer caught in such a bind, the Commission suggests that this Court either modify the holding in *Mobil Oil Corp. v. Federal Power Commission*, 463 F.2d 256 (D.C. Cir. 1971), *cert. denied*, 406 U.S. 976 (1972), to give the Commission limited jurisdiction over royalty owners, or that the Court determine that lower courts err when they interpret "market value" leases that underlie interstate sales as requiring royalty payments based on the intrastate market price of gas. Pet. 16. Neither suggestion need be considered by this Court because the Commission does have the authority to grant relief.

However, when Pennzoil and Shell petitioned the Commission for individualized relief in accordance with *Placid* and *Mobil,* they were told by the Commission that it had no authority to grant relief, as follows:

> "Accordingly, we believe that we are not free to allow royalty costs, which are based on market values, to be passed on to the pipelines as just and reasonable rates."[6]
>
> "The Commission does not have the power to base a part of the regulated price on the unregulated market value of intrastate gas."[7]

If the Commission were correct, the holding in *Placid* and *Mobil* would be meaningless. It would be idle for the Courts to state that producers "put in a bind by their royalty obligations . . . may certainly petition the FPC for individualized relief" and that "an affected producer is entitled to seek individualized relief" if the Commission does not have the authority to grant relief. The Fifth Circuit correctly noted that the Commission erred when it "failed to realize it had the authority to grant relief", 553 F.2d at 486, and correctly held that "Petitioners followed the proper procedures in petitioning the Commission for special relief and were entitled to a determination of the merits of their requests." 553 F.2d at 488.

6. *Pennzoil Producing Company and Shell Oil Company,* Opinion No. 753, Docket Nos. RI76-8, RI76-10 (January 30, 1976), Pet. 23a.

7. *Pennzoil Producing Company and Shell Oil Company,* Opinion No. 753-A, Docket Nos. RI76-8, RI76-10 (February 27, 1976), Pet. 31a.

2. This Court's opinion in *Federal Power Commission v. Texaco Inc.* is consistent with *Mobil*.

The Commission recognizes in its Petition that *Mobil* specifically authorizes an affected producer "to seek individualized relief" for "higher royalty obligations" based upon the unregulated market value, but curiously does an about face and argues that *Federal Power Commission v. Texaco Inc.*, 417 U.S. 380 (1974), denies it authority to grant individualized relief for royalty costs higher than those provided for in the regulated rate.[8] In effect, the Commission found *Mobil* and *Texaco* to be inconsistent and gave controlling weight to *Texaco*.

Texaco was handed down by this Court on the same day that this Court affirmed *Placid* in *Mobil*. This Court obviously saw no conflict between *Texaco* and *Mobil*, and no conflict exists.

In *Texaco*, this Court reviewed the Commission's Order No. 428 dealing with the regulation of "small producer" sales. The Court of Appeals for the District of Columbia had read Order 428 as providing ". . . a pure market standard for the approval of the purchased gas costs of large producers and pipelines, a standard which fell short of the requirements . . ." of the Natural Gas Act. This Court read the Order in the same manner and remanded the Order to the Commission. In *Texaco* this Court was concerned with the use of the market price as the *sole* determinant of the just and reasonable rate, thereby equating the market price and the just and reasonable rate, or, as this

8. The settlement rate in this proceeding is less than the market value, but the Commission equated the two by stating that it may not grant individualized relief "for additional royalty payments which are based on other factors than the regulated rate". Pet. 22a.

Court stated, ". . . the prevailing price in the market place cannot be the final measure of 'just and reasonable' rates mandated by the Act." 417 U.S. at 397.

The Commission indicated in its brief to this Court in *Texaco* that the standard the Commission planned to use would not be limited to market prices but would include other considerations, such as producer's costs and the amount of gas dedicated under the contract. This Court noted this *post hoc* rationale and concluded:

> "Had the order unambiguously provided what the Commission now asserts it was intended to provide, we would have a far different case to decide." 417 U.S. at 397.

Texaco proscribes the use of the unregulated market price as the *sole* standard for determining the just and reasonable rate, but it does not proscribe the use of the unregulated market price as one element to be considered in determining the just and reasonable rate. On the contrary, this Court expressly stated in *Texaco* that it did not "mean that the market price would never, in an individual case, coincide with just and reasonable rates or not be a relevant consideration in the setting of area rates . . .; it may certainly be taken into account . . ." 417 U.S. at 399. If the unregulated market price may be taken into account in setting the area rate itself, *a fortiorari* it may be taken into account in granting individualized relief from the area rate.

3. The higher royalty obligation is an actual cost, and individualized relief may be granted for higher costs.

The Commission has adopted a cost-based regulation and bases its just and reasonable rates upon estimated

industrywide average costs. This methodology was applied to a geographical area of the nation and approved by this Court in *Permian Basin Area Rate Cases,* 390 U.S. 747 (1968). The establishment of a national rate by this methodology was approved in *Shell Oil Company v. Federal Power Commission,* 520 F.2d 1061 (5th Cir. 1975), *cert. denied,* 426 U.S. 941 (1976). In *Shell,* the Fifth Circuit noted that the overall cost determination was based upon an evaluation of thirteen individual cost components, including such components as Successful Well Cost, Lease Acquisition Cost, Cost of Other Production Facilities, and Royalty Expense. Each component is the estimated actual cost of that component. For example, the estimated Successful Well Cost is determined by reference to the actual market cost of drilling and equipping a successful well, and Lease Acquisition Cost is determined by reference to the actual market cost of leases bought from private landowners and governmental entities, including the Department of the Interior. The determination is intended to take into account actual costs.

As noted in *Shell,* Royalty Expense is one of the cost components of an area rate or nationwide rate. In the overall cost determination:

> "*Royalty Expense* represents the percentage of the gross receipts which a producer must pay to the landowner for the privilege of extracting from the reserves underlying his land. It was computed by applying a percentage to the gross receipts." *Shell Oil Company v. FPC,* 520 F.2d at 1068.

In "applying a percentage to the gross receipts", the Commission treated the regulated rate itself as being the

gross receipts and applied a percentage to the regulated rate to determine the actual cost of Royalty Expense.

Some leases do provide for a landowner's royalty of a "percentage of the gross receipts", and the actual cost of the Royalty Expense of these leases is considered in the area rate or nationwide rate. However, some leases provide for a percentage of the market value of the gas, even though the market value exceeds the gross receipts from the sale of the gas, and for those leases the royalty paid is a percentage of the market value, not a percentage of the gross receipts. Since the Royalty Expense in an area or national rate determination is computed "by applying a percentage to the gross receipts" instead of by applying a percentage to the market value, the actual royalty cost in market value leases exceeds the Royalty Expense allowed in the area or national rate.

This is the exact fact situation foreseen by Mobil Oil in *Placid* and *Mobil* when it argued that for some leases it anticipated being required to pay royalties computed as a percentage of market value (not reflected in the Royalty Expense component) instead of being computed as a percentage of the regulated rate (which is reflected in the Royalty Expense component).[9] Mobil Oil's complaint in *Placid* and *Mobil* was the failure to take this anticipated higher market value royalty expense into account. This Court noted that "Mobil's argument is hypothetical at this stage and that in any event an affected producer is entitled to seek individualized relief." The

9. The Supreme Court of Texas had held in *Vela, supra,* that market value leases could require the producer to pay a royalty based on a market value rate higher than the regulated rate, and the D.C. Circuit had held, in *Mobil Oil Corp. v. Federal Power Commission, supra,* with certiorari denied, that the Commission does not have jurisdiction over royalty owners.

very situation foreseen by Mobil Oil and considered by this Court is no longer hypothetical. Pennzoil and Shell are faced with paying royalties measured by market value rather than by gross receipts. This Court has held that they are entitled to seek individualized relief, and the Commission has the authority to grant relief.

The Commission has provided for individualized relief in Section 154.105(j) of its Regulations and Sections 2.56a and 2.56b of its Statement of General Policy and Interpretations Under the Natural Gas Act (18 C.F.R. § 154.105(j) and 18 C.F.R. § 2.56a and 2.56b). The Commission has granted relief for such costs as compression and remedial well work, even though these costs are determined by an uncontrolled market, and the Fifth Circuit correctly noted that "the Commission has failed to suggest why royalty costs in an uncontrolled market are any different from any other cost." 553 F.2d at 488. *Texaco* does not proscribe rate relief for such costs as repair and maintenance of equipment, even though the actual cost for which relief is granted reflects the unregulated market value of labor and material. Neither does *Texaco* proscribe relief for actual royalty costs, even though the actual costs of the royalty reflects the unregulated market value of natural gas.

II.

NO QUESTION OF COMMISSION ABANDONMENT AUTHORITY IS BEFORE THIS COURT.

In its Petition, the Commission states that a question presented is whether the Commission has *authority* under Section 7(b) of the Natural Gas Act to permit abandonment of certificated interstate service of the royalty share of the gas and thereby permit the royalty owner to take its royalty share of the gas in kind. This question is raised for the first time in this Court.

Under Section 7(b) of the Natural Gas Act, abandonment can be granted on a showing that the available supply of gas is depleted to the extent that the continuation of service is unwarranted or that the present or future public convenience or necessity permit such abandonment. In this instance, the Commission made a determination on the merits, applying the standards of Section 7(b).

The Commission correctly held that the supply of natural gas had not been depleted and that this standard of 7(b) had not been satisfied. The Commission also held that, based upon the record, the present or future public convenience or necessity standard of Section 7(b) did not permit abandonment. It was argued to the Commission that the choice was between losing the royalty owner's share of the gas from the interstate market or risking the loss of all of the gas from the interstate market if the leases are cancelled, and, therefore it was in the public interest to grant abandonment if rate relief were denied. The Commission stated that its holding in Opinion No. 737 would prevent the royalty owners from terminating deliveries in interstate commerce even if the leases were cancelled as a result of the state court litigation. The Commission did consider the abandonment question on the merits and found that neither standard of Section 7(b) of the Act had been satisfied.

The Fifth Circuit reversed Opinion No. 737 in *Southland Royalty Co. v. Federal Power Commission, supra,*

and this Court has granted certiorari. Because the Fifth Circuit had reversed Opinion No. 737, upon which the Commission had relied, the Fifth Circuit held that the Commission was acting under the wrong legal premise and remanded this issue for further consideration on the merits.

No party to this proceeding questioned the Commission's authority to permit abandonment of the royalty share of the gas; the Commission itself did not question its authority to permit abandonment of the royalty share of the gas; and the Fifth Circuit did not question the FPC's authority to permit abandonment. The question of Commission authority to permit abandonment was not raised in the Court of Appeals and is not before this Court.[10]

10. *Neely v. Martin K. Eby Const. Co.*, 386 U.S. 317 (1967); *State of California v. Taylor*, 353 U.S. 553 (1957).

CONCLUSION

For the foregoing reasons, Respondent United Gas Pipe Line Company prays that the petition for a writ of certiorari be denied.

Respectfully submitted,

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